

APR 26 2004

IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF GEORGIA  
ATLANTA DIVISION

LUTHER D. THOMAS, Clerk  
By: *Katey L. Springs*  
Deputy Clerk

BELLSOUTH TELECOMMUNICATIONS,  
INC.,

Plaintiff,

v.

THE GEORGIA PUBLIC SERVICE  
COMMISSION, et al.,

Defendants.

CIVIL ACTION NO.

1:03-CV-3222-CC

**ORDER**

**A. Regulatory Background**

1. This case arises under the federal Telecommunications Act of 1996 (the "1996 Act").

2. The 1996 Act requires incumbent local exchange carriers ("ILECs" or "incumbents") such as plaintiff BellSouth Telecommunications, Inc. ("BellSouth") to lease some piece-parts of their networks to new entrants in local telecommunications markets. *See* 47 U.S.C. § 251(c)(3). The new entrants are known as competitive local exchange carriers ("CLECs"). The piece-parts are known as unbundled network elements or "UNEs." UNEs include such things as "local loops" (the lines strung on telephone poles or buried underground that

connect individual customer locations to the network) and “switches” (devices for routing and connecting calls).

3. The 1996 Act requires that ILECs such as BellSouth be adequately compensated for this forced leasing of their facilities. Rates for UNEs must be “just” and “reasonable,” “based on . . . cost,” and “may include a reasonable profit.” *Id.* §§ 251(c)(3), 252(d)(1).

4. Soon after passage of the 1996 Act, the FCC established rules governing the setting of UNE rates. In its 1996 *Local Competition Order*,<sup>1</sup> the FCC established a methodology known as “Total Element Long-Run Incremental Cost” or “TELRIC” that state commissions are required to use when establishing rates for access to UNEs.

5. The core requirement of the FCC’s TELRIC methodology is that UNE rates be established based on the costs that an efficient carrier would incur if it were competing in a competitive environment. In the FCC’s words, TELRIC is designed to “replicate[], to the extent possible, the conditions of a competitive market.” *Local Competition Order* ¶ 679; see also *Verizon Communications, Inc. v. FCC*, 535 U.S. 467(2002) (upholding the FCC’s TELRIC methodology).

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<sup>1</sup> First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499 (1996) (“*Local Competition Order*”) (subsequent history omitted).

6. Congress authorized state commissions such as the Georgia Public Service Commission (“PSC”) to set UNE rates in the first instance. *See* 47 U.S.C. § 252(c), (d). In setting those rates, state commissions must adhere to federal law, including the FCC’s TELRIC rules. *See id.* § 252(c); *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 385 (1999).

**B. Proceedings Before the Georgia Public Service Commission**

7. The PSC first established Georgia UNE rates in a generic ratemaking proceeding in 1997 (and concluded a related proceeding in 2000).

8. In 2001, the PSC opened the proceeding at issue here (Docket No. 14361-U) to re-examine UNE rates.

9. After discovery and hearings, the PSC issued an order on June 24, 2003 adjusting some of the 1997 rates and leaving others unchanged. *See Order, Review of Cost Studies* (June 24, 2003) (“Order”).

10. BellSouth timely filed a motion for reconsideration of the Order. Attached to BellSouth’s motion was an affidavit of Daonne Caldwell (the “Caldwell Affidavit”). The PSC granted BellSouth’s petition for reconsideration in part and denied it in part in an order entered on September 22, 2003. *See Second Order on Reconsideration* (Sept. 22, 2003) (“Reconsideration Order”).

11. In this Court, BellSouth challenges two of the decisions made by the PSC in those orders. Those challenges relate to the PSC's determinations concerning (1) a cost of capital and (2) a "growth factor." The Court will discuss the PSC's determinations as to these two issues below in the course of addressing BellSouth's arguments on these points.

### **C. Jurisdiction and Standard of Review**

12. This Court has jurisdiction over this case pursuant to the judicial review provision of the 1996 Act, 47 U.S.C. § 252(e)(6), as well as 28 U.S.C. § 1331. *See Verizon Maryland Inc. v. Public Serv. Comm'n of Maryland*, 535 U.S. 635, 644 (2002).

13. The PSC's interpretation and application of federal law are not entitled to deference. *See, e.g., MCI Telecomms. Corp. v. BellSouth Telecomms., Inc.*, 112 F. Supp. 2d 1286, 1291 (N.D. Fla. 2000), *aff'd*, 298 F.3d 1269 (11th Cir. 2002). The Court thus applies a *de novo* standard of review to the PSC's federal-law determinations, including its interpretation of the FCC's TELRIC regulations. *See AT&T Communications of the Southern States, Inc. v. BellSouth Telecomms., Inc.*, 268 F.3d 1294, 1296 (11th Cir. 2001); *Michigan Bell Tel. Co. v. MFS Intelenet of Michigan, Inc.*, 339 F.3d 428, 433 (6th Cir. 2003); *MCI Telecomm. Corp. v. Bell Atlantic-Pennsylvania*, 271 F.3d 491, 517 (3d Cir. 2001); *see also AT&T*

*Communications of Cal., Inc. v. Pacific Bell Tel. Co.*, 228 F. Supp. 2d 1086, 1099 (N.D. Cal. 2002) (holding that, where an “issue requires interpreting the FCC’s [TELRIC] regulations, the Court reviews the [state commission] decision . . . *de novo*”).

14. As to all remaining issues, the Court applies an arbitrary-and-capricious standard. *See, e.g., MCI*, 112 F. Supp. 2d at 1291.

#### **D. Cost of Capital**

15. There are three components in setting UNE rates – operating cost, depreciation, and cost of capital. *See Local Competition Order* ¶ 703. BellSouth’s first claim involves one of these three components, the cost of capital. The cost of capital is the return that investors expect for the use of their money.

16. In its August 2003 *Triennial Review Order*,<sup>2</sup> the FCC held that, consistent with TELRIC’s core assumptions, a state commission must set a cost of capital based on the risks that BellSouth would face in a competitive market with facilities-based competition, *not* the risks that BellSouth actually faces today. As the FCC stated in the *Triennial Review Order*:

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<sup>2</sup> Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 16978 (2003) (“*Triennial Review Order*”), *reversed in part on other grounds, United States Telecom. Ass’n v. FCC*, Nos. 00-1012, *et al.* (D.C. Cir. Mar. 2, 2004).

[W]e clarify that a TELRIC-based cost of capital should reflect the risks of a competitive market. The objective of TELRIC is to establish a price that replicates the price that would exist in a market in which there is facilities-based competition. In this type of competitive market, all facilities-based carriers would face the risk of losing customers to other facilities-based carriers, and that risk should be reflected in TELRIC prices.

*Triennial Review Order* ¶ 680.

17. The FCC's Wireline Competition Bureau reiterated this same legal point in its recent Memorandum Opinion and Order, *Petition of WorldCom, Inc.*, 18 FCC Rcd 17722 (2003)) ("*Virginia Pricing Order*"). In that case, the Wireline Competition Bureau made clear that the "central conceptual issue" it faced in establishing a cost of capital was "what assumptions to make with respect to competition in assessing the risk Verizon faces." *Virginia Pricing Order* ¶ 60. The incumbent provider (Verizon) argued there, just as BellSouth does here, that the FCC's TELRIC requirements mandate that a decision maker assume the existence of a highly competitive market in calculating a cost of capital. *Id.* ¶ 61 (noting Verizon's claim that "TELRIC assumes more competition than exists today"). AT&T and MCI, by contrast, argued that the FCC should instead "look at the existing level of competition" and the "actual risks faced by an incumbent" in setting a cost of capital. *Id.* ¶ 62.

18. Relying on the *Triennial Review Order* discussed above, the FCC bureau accepted Verizon's argument and rejected the argument of AT&T and MCI. The bureau explained that the *Triennial Review Order* "clarified that a TELRIC-based cost of capital should reflect the same competitive assumptions that are used to determine network investment. Based on this clarification we agree with Verizon that the cost of capital used in this proceeding *must reflect the risks of a market in which Verizon faces facilities-based competition*, and that AT&T/[MCI's] assumption that Verizon is, and will remain, the dominant local telephone company cannot form the basis of our cost of capital decisions." *Id.* ¶ 63 (footnote omitted and emphasis added). As the FCC bureau further explained, the *Triennial Review Order* "made clear that, in establishing a TELRIC-based cost of capital, state commissions must reflect the risk of participating in a market with facilities-based competition." *Id.* ¶ 31.<sup>3</sup>

19. BellSouth argues that the PSC did not adhere to the FCC's TELRIC requirements in establishing its cost of capital. In this regard, BellSouth is arguing only that the PSC did not apply the legal standard required by the FCC's orders.

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<sup>3</sup> The FCC bureau is entitled to deference in its interpretation of the FCC's rules. See *MCImetro Access Transmission Servs., Inc. v. BellSouth Telecomms., Inc.*, 352 F.3d 872, 880 n.8 (4th Cir. 2003).

BellSouth does not challenge the PSC's weighing of evidence, nor does it contest any discretionary judgment of the PSC.

20. Because BellSouth's claim raises a question of law – whether the PSC has employed the cost-of-capital methodology mandated by the FCC – the Court applies *de novo* review. See, e.g., *MCI*, 112 F. Supp. 2d at 1293-94 (when the “dispositive [TELRIC] issue . . . is which agency's view – the FCC's or the [state] Commission's – will prevail,” review is *de novo* because the question is one of law).

21. Consequently, the legal question before the Court is whether the PSC abided by the federal-law standard clarified in the *Triennial Review Order* and the *Virginia Pricing Order*. The Court must determine whether, as those FCC orders require, the PSC established a cost of capital based on the risk of competing in a telecommunications market with facilities-based competition, or whether the PSC instead mistakenly relied on the actual risk that BellSouth faces.

22. The Court concludes that the PSC did not adhere to the FCC's TELRIC requirements in establishing BellSouth's cost of capital. Under TELRIC, the cost of capital must be based upon the risk that BellSouth would face in a competitive market with multiple facilities-based providers, not the risk that BellSouth actually

faces to date or currently. The PSC's orders establish that the agency instead employed an improper actual-risk standard.

23. The PSC first set a cost of capital for BellSouth in establishing UNE rates in 1997. The PSC's order in that proceeding makes clear that the PSC inquired into BellSouth's actual risk at that time in setting a cost of capital of 9.27%. The PSC stated that it had "assessed investor expectations for telecommunications companies in general, and BellSouth in particular, in the *current* environment of increasing deregulation and competition." Order, *Review of Cost Studies, Methodologies, and Cost-Based Rates for Interconnection and Unbundling of BellSouth Telecommunications Services*, Docket No. 7061-U, at 24 (Ga. PSC Oct. 21, 1997) (emphasis added).

24. In the orders at issue here, the PSC decided to retain the 9.27% cost of capital set in 1997 because it believed that *actual* competition in telecommunications markets had not increased sufficiently to warrant a higher cost of capital. The PSC stated that "[t]here is no indication that competition in the telecommunications market has increased so significantly [from 1997] that the market risk to BellSouth warrants the Commission establishing [the] 11.25 percent cost of capital" that BellSouth had advocated. Order at 34.

25. That quotation makes plain that, to the PSC, the relevant question was whether actual telecommunications competition in Georgia had increased to a degree that would justify a higher cost of capital. As a matter of federal law, that is the wrong question. Under the FCC decisions discussed above, to apply TELRIC properly, a state commission must consider the risk that BellSouth would face in a competitive market with facilities-based competition, not the risk that BellSouth actually faces today in Georgia.

26. The PSC's use of an improper actual-risk standard is also evident from its statement that retaining 9.27% as BellSouth's cost of capital was appropriate because "competition has been slow to materialize" in telecommunications markets. *Id.* Again, the speed by which competition has in fact been developing in telecommunications markets is relevant only if, contrary to the FCC's orders, the PSC was assessing actual risk in determining a cost of capital. The PSC's statement thus reveals that it was applying the wrong legal standard.

27. Indeed, in its brief to this Court, the PSC does not dispute that it relied on BellSouth's actual risk in establishing a cost of capital, but argues that it acted "within its discretion" in doing so. PSC Br. 17. The PSC's position cannot be squared with the *Triennial Review Order* and the *Virginia Pricing Order*, both of

which rejected arguments that actual risk is an appropriate standard for establishing a TELRIC cost of capital.

28. The Court is aware that the PSC labeled its approach “forward-looking.” The label the PSC assigned to its methodology, however, does not show that, as a substantive matter, the PSC abided by the FCC’s binding guidance. *See MCI*, 271 F.3d at 521-22 (courts must review the “substance” of the state commission pricing decision, not the “nomenclature” used by the state commission). To adhere to the FCC’s orders, the PSC was required to set a cost of capital based upon the future risks BellSouth would face in a fully competitive market. As discussed above, the PSC’s orders establish that the PSC did not follow that approach.

29. Applying *de novo* review, the Court concludes that the PSC erred by failing to apply the proper legal standard for establishing a cost of capital. Accordingly, the matter is remanded to the PSC to establish a cost of capital for BellSouth consistent with the proper federal law cost-of-capital standard.

#### **E. Growth Adjustment**

30. In setting rates for some UNEs (loops and loop-related elements), the PSC considered future growth in the number of lines/loops that BellSouth serves. BellSouth claims that the PSC acted arbitrarily and capriciously in not adopting the

2002 line count information set forth in the Caldwell Affidavit that was attached to its motion for reconsideration.

31. The PSC contends that it would have been contrary to its rules (in particular, GPSC Rule 515-2-1-.08) to rely upon such a document attached to a reconsideration motion without re-opening the record and allowing cross-examination as to the new figures provided in the Caldwell Affidavit. At the same time, however, the PSC concedes that it relied on the *same* Caldwell Affidavit to adjust the 1998 through 2001 inputs that the PSC used in adopting its growth factor.

32. Both BellSouth and the CLECs have stated that, for different reasons, the PSC acted arbitrarily and capriciously in its consideration of the affidavit attached by BellSouth to its motion for reconsideration. The Court agrees. Without reopening the evidence, the PSC considered portions of the Caldwell Affidavit while rejecting the remainder. The Court hereby remands this issue to the PSC for a determination regarding the admissibility of the Caldwell Affidavit consistent with its rules and the Georgia Administrative Procedure Act.

33. Second, and independently, the PSC acted arbitrarily and capriciously by determining that the growth BellSouth will allegedly experience would come at no additional cost.


34. The PSC's order assumed no cost for line growth to new locations. Rather, the PSC used "fill factors" in BellSouth's cost model as a proxy to compensate BellSouth for new growth. The Court cannot agree that this analysis is rational. There necessarily are some costs associated with new growth.

35. The PSC's emphasis on "fill factors" does not change that conclusion. "Fill factors" involve spare capacity on *existing* facilities – not on facilities that have yet to be built. *See, e.g.,* Notice of Proposed Rulemaking, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements*, 18 FCC Rcd 18945, ¶ 73 (2003) ("A fill factor represents the percentage of the capacity of a particular facility or piece of equipment that is used on average over its life."). The existence of spare capacity on some existing facilities does not mean that BellSouth will incur no additional cost when building new facilities. In sum, if the PSC chooses to model growth, it must also rationally determine the costs associated with that growth.

36. WHEREFORE, having considered the evidence of record in this case and having heard oral argument in opposition to and in support of BellSouth's challenge to the UNE rates set by the Georgia Public Service Commission, the Court hereby REMANDS this matter to the PSC for reconsideration of its cost of capital and growth rate determinations in accordance with this Order. Further, in

accordance with the pronouncement made by the Court at the January 6, 2004 hearing on BellSouth's motion for stay, after new rates have been established by the PSC in accordance with this Order, the PSC is ordered to ensure that BellSouth is made whole for any damages BellSouth has suffered as a result of the prior rates established by the PSC in its June 24, 2003 and September 22, 2003 orders from the effective date of those orders.

SO ORDERED, this 6<sup>th</sup> day of April, 2004.

  
Honorable Clarence Cooper  
United States District Judge

IN THE UNITED STATES DISTRICT COURT  
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ATLANTA DIVISION

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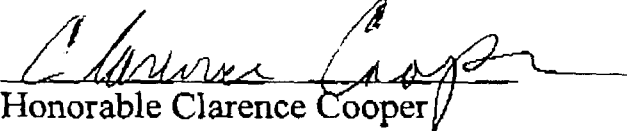
**FINAL JUDGMENT**

This case is before the Court on BellSouth Telecommunications Inc.'s ("BellSouth") Complaint for Declaratory and Injunctive Relief. After reviewing the briefs on the merits submitted by the parties and hearing oral argument on March 18, 2004, the Court enters judgment as follows:

This action is hereby REMANDED to the Georgia Public Service Commission ("PSC") for reconsideration of the cost-of-capital and growth factor issues challenged in this matter, and the PSC is ORDERED to ensure that BellSouth is made whole for any damages BellSouth has suffered as a result of the prior rates established by the PSC in its June 24, 2003 and September 22, 2003 orders from the effective date of those orders.

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SO ORDERED, this 6<sup>th</sup> day of April, 2004.

  
Honorable Clarence Cooper  
United States District Judge